PISM | POLSKI INSTYTUT SPRAW MIĘDZYNARODOWYCH
THE POLISH INSTITUTE OF INTERNATIONAL AFFAIRS

INEKO
Inštitút pre ekonomické a sociálne reformy

STRATEGIC FILE

No. 3 (39), February 2014 © PISM

Editors: Marcin Zaborowski (Editor-in-Chief) ● Maya Rostowska (Managing Editor)
Jarosław Ćwiek-Karpowicz ● Artur Gradziuk ● Piotr Kościński
Roderick Parkes ● Marcin Terlikowski

Solutions to Public Debt Crises in the EU: Seek Returns on That Investment[1] (Views from Slovakia)

Peter Goliaš, Eugen Jurzyca[2]

The purpose of providing financial assistance to indebted eurozone countries is to avoid uncontrolled bankruptcies that could lead to a breakdown of the euro area with severe negative consequences for all members of the EU. There is a high probability that the loans provided via the stability mechanisms will not be fully recovered. Nevertheless, the long-term benefits of those loans are expected to exceed the costs. Therefore, this form of financial assistance should be regarded as an investment that has its own rate of return, one that can be controlled for by insistence on adherence to certain rules of behaviour and diligent oversight.

Slovakia, along with the other eurozone Member States, is a participant in the financial aid programmes that currently provide assistance to Greece, Portugal, Ireland, Spain and Cyprus. Slovakia has taken part in all of the rescue programmes implemented in the eurozone with the exception of the first Greek bailout. Its total contribution exceeds €2.6 billion, or 3.6% of its GDP in 2013 (see Annex), and its total participation in the European Stability Mechanism (ESM) accounts for 7.1% of its GDP.

It was not easy to approve such large amounts of money for the common European project. The decisions about eurozone bailouts and the introduction of safety mechanisms have aroused intense public debate in Slovakia. As a consequence, it became the only eurozone country that refused to participate in the first bailout of Greece. The failed vote on the expansion of the European Financial Stability Facility (EFSF) and resulting fall of the right-wing government in 2011 caused a deep rift between the liberal SaS party and the country's three other right-wing parties.

The left-wing SMER party benefited the most from the political instability. After preliminary elections took place in 2012, SMER took power and its chairman, Robert Fico, became prime minister. Although Fico is often regarded as a populist politician in Slovakia, he holds pro-European attitudes and an interest in deeper integration within the EU, even at the cost of a partial loss of national sovereignty. Fico is of the opinion that the solution to the debt crises in the EU Member States is not austerity but stronger economic growth, ignited by more intense public investment.

---

[1] This text was written under the project "Time for the Third Step? The V4+ and the Eurozone Accession," supported by the International Visegrad Fund. The project is led by the Polish Institute of International Affairs (PISM) and coordinated by PISM analysts Dariusz Kałan and Patryk Toporowski. The paper specifies some of the proposals discussed during the workshop "Crisis in the Eurozone: Slovak Experiences with the Common Currency," which took place on 22 November 2013 in Bratislava. The paper was also prepared thanks to the financial support from the Think Tank Fund—Open Society Foundations.

[2] Peter Goliaš is director of the Institute for Economic and Social Reforms (INEKO), based in Bratislava, Slovakia. Eugen Jurzyca is founder of INEKO and still works as a consultant to the institute. INEKO is one of PISM's partners in the project.

In the midst of this intense debate, many Slovak economists believe that the best solution to the crisis is to provide support to indebted countries, conditional on the implementation of stabilisation measures. A survey of 21 economists in the country, carried out by the INEKO think tank in Bratislava, overwhelmingly marked "implementing structural reforms" as the most efficient solution (this answer averaged 3.81 out of 4, the maximum) followed by "completing the Banking Union" (2.95) and "more austerity" (2.81).[3] Such structural reforms would have to happen at both the national and EU levels.

The Philosophy behind Financial Assistance

There is a high probability that the loans provided to indebted countries in the eurozone via the stability mechanisms will not be fully recovered. By now we have seen a controlled "haircut" of the Greek debt (private creditors lost 75% of their claims in early 2012) and extensions of the loan rescue mechanisms by seven years for both Portugal and Ireland in 2013. With the countries taking financial support still burdened by heavy debt, it is highly probable that additional "haircuts" are yet to come. The key question is whether there is some alternative that would mean lower costs to countries providing the financial assistance and what should be done to recover the most money.

Proposal 1: Require Strongly Conditional Assistance

The sense in providing financial assistance to indebted countries (e.g., transfers from rescue funds, debt restructuring, ECB intervention, etc.) is to avoid the uncontrolled bankruptcy of indebted countries, which could lead to a breakdown of the eurozone with severe negative consequences for all members of the EU or even a sort of financial chaos that would appear to a great extent even without a breakdown. In other words, the long-term benefits are expected to exceed the costs associated with the newly established rescue mechanisms. Therefore, the financial help should be regarded as an investment that has its own rate of return. Similar to bankruptcies in the private sector, creditors often have to give up some part of their claim in order to preserve the healthy parts of the bankrupt firm. It is in the creditors' interest (and that of broader society) to recover some portion of their claims and to make the firm healthier in order to continue to produce a return. By writing off a portion of their claims, creditors in fact are making an investment into the bankrupt firm and, if it recovers, will collect on the remaining claims and possibly profit on future revenues, i.e., they are seeking to maximise the rate of return on their investment.

The basic philosophy of private and public bankruptcy is the same: how to make sure that the creditors get the highest possible return on their investments. In the private sector, the bankrupt firm has to meet certain conditions agreed by creditors, such as caps on expenditures, employee dismissals, changes to its product portfolio and cost cuts. Similarly, creditor countries can influence their rate of return by setting conditions on the indebted countries that help it regain its competitiveness and by enforcing the implementation of these conditions.

Proposal 2: Enforce Independent and Centralised Supervision over Public Finances

The interventions to stabilise the eurozone have brought relief from market pressure. This was clearly visible in 2012 after the European Central Bank announced its Outright Monetary Transactions (OMT) programme, which promised to support any eurozone member asking for financial assistance with an unlimited purchase of its government bonds on secondary markets, provided the government adopts stabilisation measures. These interventions restored confidence in the euro and brought down the government bond yields of eurozone members, thereby decreasing their borrowing costs and providing them with time to adopt structural reforms. However, the interventions have also brought higher risks of moral hazard, such as the risk of delaying necessary measures.

To prevent moral hazard, the European Commission, as well as formal debt brakes and budget councils, should guard the public debt and deficit levels of affected eurozone members, both in the short-term and in the long-term. The Stability and Growth Pact was designed to meet this purpose. Unfortunately it proved

[3] The survey respondents included participants in the workshop "Crisis in the Eurozone: Slovak Experiences with the Common Currency," which took place on 22 November 2013 in Bratislava.

to be too weak and was circumvented too often. It is important that the Fiscal Compact signed in 2012 better serves its purpose.

In the longer term, it will probably be necessary to go even further and centralise some of the competences of the various Member States' ministries of finance, especially with respect to constituting and controlling the public budgets. This centralisation should concern particularly those countries running excessive public deficits.

Proposal 3: Implement Structural Reforms

The financial support provided to indebted countries should be conditioned on structural reforms, such as the introduction of a more flexible labour code, higher pension age, higher fees for healthcare and tertiary education, and more transparent public procurement. The conditions should include cuts in public expenditures, privatisation and the completion of the single market for goods and services. Every country should have a roadmap for implementing structural reforms for the decade ahead.

Recently, there has been intense discussion in the EU and around the world about what should be the priority in solving the current debt crisis—austerity measures (i.e., reducing the budget deficit during adverse economic conditions) or supporting economic growth. The solution to this dilemma is tricky because for a highly indebted country, neither austerity nor higher economic growth driven by higher public investment may lead to a reduction in public debt.

What other options does a highly indebted country have if it wants to reduce its debt? It may sell some assets and reduce its debt with these revenues from privatisation. It may also foster growth by implementing structural reforms and by improving the efficiency of public expenditures. These measures should be an essential part of the solution to the EU debt crisis because they guarantee long-term public finance sustainability. However, this is also a hard task because it requires the implementation of unpopular measures. After making the necessary structural changes, even the impact of austerity may be different in the long term. Unemployment does not have to rise or remain high if there is a flexible labour market. People may simply get used to working for lower salaries as they did for centuries before. Social benefits also do not have to increase and, in the long-term, they should be falling if public revenues decline.

Systemic Changes to Be Implemented at the EU Level

Economies do not perform in a vacuum. In today's globalised world, they are highly interconnected at various levels. This interdependence is particularly visible in the case of the eurozone and means that sound governance by the Member States alone is not sufficient to ensure a stable rise in prosperity. Governance of the entire group is needed in addition to state regulation in order to avoid or soften the negative aspects of this interdependence. Furthermore, this governance should be optimal and verifiable. In order to improve the current governance system, several issues should be better implemented: the deepening of the fiscal union, completion of the banking union, reform of sovereign debt-linked rules, reduction of the 100% guarantee for bank depositors, and including non-eurozone EU members in rescue programmes.

Proposal 4: Build a Deeper Fiscal Union

The eurozone was built as a monetary union with limited fiscal transfers from cohesion and structural funds. It did not envision massive fiscal transfers to solve macroeconomic imbalances for specific members. However, the deeper level of economic integration fuelled by the common currency is now such that the macroeconomic problems of one member create high risks for the others. This was the case when Greece asked for financial aid from the other eurozone countries in 2010 and 2012, later followed by Ireland, Portugal, Spain and Cyprus. Suddenly, massive financial transfers (mostly in the form of guarantees of government debt) among members of the eurozone became a reality.

This development proved that deeper economic integration among members of the monetary union requires a deeper fiscal union. A deeper fiscal union means financing standard fiscal expenses from a common budget. The use of cohesion and structural funds should reflect this new reality. It would be better to allow the use of those funds to pay for expenses typical of any fiscal union, including individual

states. For example, eurozone members should be allowed to use money from cohesion and structural funds to pay for their contributions to the European stability mechanisms. At the same time, the efficiency of current common spending programmes (including Common Agricultural Policy) should be evaluated, and inefficient spending should be stopped.

In the long run, the fiscal union will probably deepen even more. For example, greater mobility of the labour force means that people educated in one country may easily find a job and move to another country. Thus, their home country would pay for their education but would not collect the taxes they pay in the host country. Similar problems appear in states when people move from the countryside to urban areas. The generally accepted solution is that the state compensates these rural areas by transfers from the state budget, for example, by funding teachers' wages. Otherwise, those who live there would not be able to pay for good teachers to teach children born in remote areas, leaving them with a poor education which in turn may increase poverty rates or demands on social services. Sooner or later, the same solution has to be applied to an economically integrated (monetary) union. Even now, the member countries should be allowed to use the cohesion and structural funds in this manner.

As well, the process of building the fiscal union should not harm individual member states' competitiveness.

Proposal 5: A Complete Banking Union

The crisis has shown in Greece, Ireland, Spain and Cyprus that these states have been unable to prevent and solve problems with their banks, thus the European stability mechanisms have had to bridge the gap. If common funds are being used either to rescue failing banks directly (as in Spain) or to finance governments that bailed out the banks (as in Ireland) it is logical that the need for a common banking union has become imminent.

From 2014, the ECB will take up the common supervision of 128 of the most significant eurozone banks. From 2015, the rules for bank recapitalisation should be harmonised and a common resolution fund set up and strengthened gradually over a 10-year period to €55 billion. However, there are doubts about the capacity of the common resolution fund to solve a potential banking crisis, especially during the transition period. It is also unclear what a common deposit-guarantee scheme would look like. The taxpayers from countries with healthier banks would probably be less willing to pay for sick banks in other countries. Without sufficient common backing, however, the national governments might refuse to take over the bad debts of banks looking to avoid bankruptcy. In such a case, the protracted malaise of these banks would drag down economic growth for much longer than if they had been rescued, and this could potentially infect the whole eurozone. So, a quick resolution seems to be a better choice. However, to prevent the risk of moral hazard, any bank recapitalisation from common funds should be conditional upon adopting structural reforms in the financial sector and the economy. It should be a last resort option and not a way to avoid dealing with the Troika's demands.

The full implementation of the banking union should include the completion of a single market for banking services that would enforce availability to customers and, thus, competition among banks all over the region. Administrative barriers to enter and operate on national markets should be diminished and healthy foreign banks should have an equal opportunity to operate where local banks have failed.

Proposal 6: Introduce Non-Zero Risk Weights for Sovereign Debt

The EU Capital Requirements Directive allows for zero-risk weights for the sovereign debt of EU Member States denominated in the domestic currency. This means that banks do not have to build reserve capital when investing in bonds denominated in their home currency. This has several negative effects:

- Investment into government bonds squeezes out private investment.
- Easier access to money reduces government's motivation to implement structural reforms.
- Under-capitalised banks especially have an incentive to invest into domestic government bonds and the link between banks and governments becomes stronger. The evidence can be seen in the

recent surge in the share of domestic government bonds in the total assets of Portuguese, Italian, Irish and Spanish banks.

These effects may result in the delay of necessary reforms as well as in tight monetary conditions (such as overly expensive loans for businesses) in countries where the optimal monetary policy would need to be accommodative. To solve these imbalances and prevent undue investment into risky sovereign debt, it is necessary to introduce non-zero weights for domestic government bonds.

Proposal 7: Establish a Debt Resolution Scheme for Sovereign Debt

We know now that the public debts of several eurozone countries had increased to unsustainable levels, burdening their public budgets and dragging down economic growth. When this happens, the necessity for controlled sovereign debt restructuring becomes evident. In order to offer relief to most of the indebted countries and to impose market pressure and its disciplinary effects on eurozone members, it is important to create a scheme for sovereign debt resolution in which private investors would bear at least some portion of the costs. The correct pricing of the default risk would also prevent countries from running a high debt or primary deficits, i.e., it would reduce moral hazard.

Proposal 8: Reduce the 100% Guarantee for Depositors

Should depositors bear some costs of bank recapitalisation? This has already become reality in Cyprus, although only for uninsured depositors. Officials quickly denied that the same approach would be applied to other countries as the risk of bank runs was too high. But the logic is clear: why should taxpayers pay for a bank's recapitalisation if the depositors do not bear any cost at all? The depositors take profits, so they should also take some responsibility for the shape of their bank. If depositors knew they might lose some money they would likely be more cautious when choosing the bank. This would create the pressure required for a healthy banking sector to grow. Therefore, the 100% guarantee for depositors holding less than €100,000 should be decreased so that all depositors would bear some costs of a bank's recapitalisation.

Proposal 9: Include Non-Eurozone Members of the EU in the Rescue Programmes

The INEKO survey showed an exact split amongst Slovak economists about whether only eurozone countries should participate in the rescue programmes or if other EU members should also be included. Those who favour the first option mentioned that the aim of the programmes is to save the euro as a common currency, and therefore it is only in the vital interest of the countries using the euro. Those who argue for the second option note that due to the EU's deep economic integration, a spontaneous bankruptcy of an indebted member and the potential for the breakdown of the eurozone would harm all EU members in almost the same way, regardless of their currency.

This question is especially sensitive for Slovakia because all of the other members of the Visegrad Four, i.e., Czech Republic, Hungary and Poland, use their own currencies and do not have to participate in the EFSF or ESM. Thus, they do not have to bear the financial burden of these mechanisms. The same is valid for Finland which is the only participating Scandinavian country.

The Importance of Communication

The public across the EU should understand the risks associated with high debt and should also have information about the changes occurring in those states accepting international financial aid. All countries participating in financial aid mechanisms should actively join the discussion about the further changes necessary for the sustainability of public finances and for strengthening the competitiveness of the beneficiary countries. Transforming overly indebted countries into competitive and prosperous economies with sustainable public finances is in fact crucial for the effective use of outside investments, which comes in the form of financial assistance from members of the euro area, including Slovakia.

Proposal 10: Focus on Public Education

Even in times of strong economic growth, public debt in most of the world's richest economies and developed democracies was growing—or at least not declining at a sufficient rate. According to the debt database of the International Monetary Fund (IMF), the average gross public debt of five peripheral EU Member States—Portugal, Italy, Ireland, Greece and Spain—increased gradually from 26% of GDP in 1970 to 130% in 2013. In the same period, the public debt of Japan exploded from 12% of GDP to 245%. Public debt was also growing, even though less dramatically, in the U.S. (from 36% to 112%), France (from 21% to 92%), Germany (from 18% to 82%), Canada (58 to 88%), and the United Kingdom (from 73% to 93%). The decades-long stagnation in Japan and Italy, a credit rating downgrade and the political turmoil over debt limits in the U.S., as well as the recent bailouts of some eurozone members are just some of the examples of the negative consequences of this spiralling debt.

How is it possible that so many democratic countries have let their debt grow so high? The root cause is that the public has not been fully aware of the potential threats of such indebtedness. This has led to a higher tolerance of debt increases and lower pressure on politicians to behave responsibly. Voters in democratic elections frequently refuse to elect politicians who are willing to implement necessary, but sometimes painful reforms. As the steep public debt rise in many democratic countries over the past four decades confirms, the politicians who make generous promises that entail higher public debt are often more successful.

Public education campaigns and relevant changes in education curricula could significantly help to resolve this problem by improving the public's understanding of the risks associated with high debt and would encourage the electorate to view politicians more critically and better appreciate the need for difficult reforms. Although formal debt brakes and budget councils (i.e., institutions independent from national governments) that guard public debt are important, there is a risk that irresponsible politicians would eventually warp such rules and institutions if voters do not change their thinking. As a result, the seemingly spontaneous and more painful solutions to the debt crises that have already become reality in some of the peripheral EU member states would, by necessity, become more frequent.

Proposal 11: Monitor and Inform the Public about Structural Changes Adopted by Countries Taking Financial Assistance

To show the efforts of particular governments in fiscal consolidation, it is useful to check the development of the primary structural balance, i.e., the cyclically-adjusted primary balance (net of interest payments) excluding one-off and other temporary measures. The IMF Fiscal Monitor from April 2013 shows an enormous effort by Greece to reduce its primary structural deficit by around 15% of GDP in 2009–2012. In Portugal, the reduction was almost 8% of GDP in the same period, while in Ireland and Spain it was around 6% of GDP.

This index is, however, not sufficient to assess the degree of the countries' achievements in enacting reforms. In order to better inform the public about ongoing changes in beneficiary countries, the regular disclosure of a clear and detailed comparison of the reform measures and competitiveness indicators of all the countries benefiting from such assistance should be published. The description of these measures should be detailed and should, for example, include a schedule for the extension of the retirement age, the length of the employer-financed severance pay, and the notice periods when dismissing employees both before and after the reform for the relevant groups of workers.

It is crucial for the public that ultimately gives their money to rescue these indebted countries to have an overview of the ongoing changes and to be able to form an opinion about the effectiveness of the use of these rescue resources. Otherwise, there is an increased risk of the possibility that an uninformed public, whether in Slovakia or another eurozone country, will not learn from these crises and that it would reject future proposals to provide help even if the aid would be effective or vice versa, that the public would back a proposal even if the aid would be ineffective.

Proposal 12: Disclose of Hidden Public Debt

To avoid increases in bond yields or sanctions imposed by official debt brakes or the fiscal compact, governments might be tempted to hide some of their debts or not to display them on their public financial balance sheets or official public debt registers. According to INEKO observations, the most common ways of hiding debt used in Slovakia are the use of public-private partnerships (PPP) and transferring debt to public companies.

According to Eurostat, PPP projects may be excluded from the public finance balance sheet as long as the private investor takes on the construction risk (i.e., the commitment to build a certain facility in a given timeframe and by fulfilling quality criteria stated in the contract) and one of two other risks, either the availability risk (i.e., the commitment to make the facility available during a given time period according to the quality control criteria stated in the contract) or the demand risk (i.e., the commitment to cover payments for using the facility for a given time period regardless of changes in demand for the services it offers). In practice, the governments are tempted to transfer the construction risk and the availability risk to a private investor and to take the full demand risk on themselves. The problem is that this setup is many times used for the construction of public facilities in which the fees collected from end-users covers only a fraction of the instalments agreed under the PPP contracts. Thus, the uncovered part of the instalment in fact becomes government debt. In Slovakia, a PPP contract was used to build a highway, creating hidden debt amounting to 3% of GDP.[4] According to the EIB (2010),[5] all of the eurozone countries taking financial support from the stability mechanisms are among the top users of PPP projects. The world's number one is Portugal, where PPP projects amounted to more than 10% of GDP.

To prevent the extensive use of PPP projects to obscure public debt rather than increasing efficiency, the EU should redefine its rules for including PPP projects on the public finance balance sheet and public debt register. These projects should be included where the government takes the full demand risk and the fees collected by end-users do not cover a substantial part of the instalments agreed under the PPP contracts.

The governments also might hide its debts by transferring them to state companies, such as railway and highway operators, state hospitals, etc. Therefore, the debts of government-owned corporations should also be included in the public debt totals. Another specific type of hidden public debt is uncovered pension liabilities, particularly from pay-as-you-go (PAYG) public pension schemes. The EU should adopt an accrual accounting system for pension liabilities that would disclose this type of debt.

This *Strategic File* was drafted within the framework of the project "Time for the Third Step? The V4+ and the Eurozone Accession" supported by the International Visegrad Fund.

[4] See, "Public Budget for 2014–2016, Annex number 6," Ministry of Finance of the Slovak Republic, 2013, www.finance.gov.sk/Default.aspx?CatID=9521.

[5] "Economic and Social Report 2010/04," European Investment Bank, July 2010, referred to in the OECD presentation by Prof. Ricardo Ferreira Reis, www.oecd.org/gov/budgeting/49945426.pdf.

ANNEX

Table: Slovakia's Participation in Eurozone Rescue Packages

		Greece	Portugal	Ireland	Spain	Cyprus
Total aid, million EUR		245,600	78,000	67,500	41,400	10,000
Bilateral	Total	52,900	-	4,800	-	-
	Slovak share (0.00%)	0	-	0	-	-
IMF	Total	48,100	26,000	22,500	-	1,000
	Slovak share (0.18%)	87	47	41	-	2
EFSF	Total	144,600	26,000	17,700	-	-
	Slovak share (0.99%)	1,432	257	175	-	-
ESM	Total	-	-	-	41,400	9,000
	Slovak share (0.82%)	-	–	-	341	74
EFSM	Total	-	26,000	22,500	-	-
	Slovak share (0.37%)	-	96	83	-	-
Total Slovak share, million EUR		1,519	400	299	341	76
		2,635 (3.61% of GDP in 2013)				

Source: INEKO

IMF—International Monetary Fund

EFSF—European Financial Stability Facility

ESM—European Stability Mechanism

EFSM—European Financial Stability Mechanism